No. 12295

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

NATIONAL BRASS WORKS, INCORPORATED,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF FOR PETITIONER.

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I.
JURISDICTION.

Under Section 272(a) Internal Revenue Code, respondent, on January 21, 1947, by registered mail, sent a notice of deficiency to petitioner. [R. 8.]

Petitioner, on April 4, 1947, filed its petition with The Court of the United States. [R. 11.] On March 25, 1949, The Tax Court entered its decision that there is a deficiency in income tax of $2,911.85 for the year 1944. [R. 84.]

Under Sections 1141 and 1142, Internal Revenue Code, petitioner, on June 3, 1949, filed its petition for review [R. 92], and on June 8, 1949, filed its notice to respondent of said filing with this Court because within its circuit is located the Collector's Office at Los Angeles, to which was made the return of tax in respect of which the liability arises. [R. 13.]

II.
STATEMENT OF THE CASE.

Basic Facts.

1. Petitioner makes and sells nonferrous copper base castings in Los Angeles. [R. 13.]

2. Revised Maximum Price Regulation 125, effective February 1, 1943, reduced the price of all petitioner's castings 1½ cents per pound, even on contracts wherein prices were fixed prior to February 1, 1943. [R. 15 and 28.]

3. Petitioner did not reduce its prices. [R. 15.]

4. Amendment #3 to R. M. P. R. 125, effective February 1, 1944, restored ½ cent (on certain specifications) and ¼ cent (on other specifications) of the former price reduction on the castings sold by petitioner. [R. 72 and 73.]

5. Two O.P.A. Investigators examined petitioner's books. [R. 15.]

6. The O.P.A. alleged that petitioner had violated R. M. P. R. 125. [R. 15.]

7. Petitioner paid to the O.P.A. Administrator $13,071.08 in settlement of his claim for treble damages based on overcharges on sales between February 1, 1943, and February 1, 1944. [R. 15 and 16.]

Mitigating Circumstances.

8. Petitioner purchased all its nonferrous ingot metal from H. Kramer & Co., Chicago, Illinois. [R. 14.]

9. On August 19, 1942, Kramer & Co., under M. P. R. 202, reduced the price of nonferrous metal ingots to petitioner 1½ cents per pound on some specifications and 1¼ cents per pound on other specifications but charged transportation costs of ¾ cent per pound (the excess over ¼ cent per pound permitted to be charged by M. P. R. 202), which it had not formerly charged petitioner. [R. 14 and 15.]

10. This resulted in a net reduction in metal ingot cost to petitioner of ¾ cent and ½ cent per pound, depending upon the ingot specification. [R. 14 and 15.]

11. The straight 1½ cents price reduction on all copper base nonferrous castings after February 1, 1943, regardless of specifications, was to pass on to consumers the price reduction effective August 18, 1942, by M. P. R. 202 and other O.P.A. orders. [R. 18.]

12. Petitioner, through its president, Mr. Leonard Ruegg, had reduced prices on contracts entered into after February 1, 1943, and had been trying for some time to get price adjustment on contracts entered into prior to February 1, 1943, on account of the inequities of the situation when O.P.A. Investigators appeared at his office. He settled their claim for overcharges by paying the exact amount of the overcharge. These two facts are not proved because Mr. Ruegg died before this case was tried and all O.P.A. records of the Los Angeles office had been destroyed. Petitioner's books and records do not contain evidence of these facts.

III.

SPECIFICATIONS OF ERRORS RELIED UPON.

The Tax Court erred—

1. In deciding that there is a deficiency in petitioner's income tax of $2,911.85 for the year 1944.

2. In deciding that a payment of $13,071.08 by petitioner in July, 1944, to the Administrator of O.P.A. in settlement of his claim for treble damages is not an ordinary and necessary business expense, deductible from petitioner's gross income under Section 23(a)(1), Internal Revenue Code, which reads as follows:

> "Sec. 23. Deductions From Gross Income.
>
> In computing net income there shall be allowed as deductions:
>
> (a) Expenses—
>
> (1) In general. All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *."

ARGUMENT OF THE CASE.

POINT I.

The Payment of $13,071.08 to the Administrator in Settlement of His Claim for Treble Damages on Account of Overcharges Made to Customers Is Not the Payment of a Penalty, but Is a Deductible Business Expense.

In *Jerry Rossman Corporation v. Commissioner of Internal Revenue* (U. S. Court of Appeals, 2d Cir., July 5, 1949), Judge L. Hand, in dealing with the deductibility of a payment to the Administrator in settlement of his claim for treble damages, reversed the Tax Court which had disallowed the deduction. Judge Hand said:

> "Hence, we hold erroneous the order assessing the deficiency. First, we say that on no theory was the payment of the overcharge to the United States the payment of a 'penalty.' Second, we say that even if it was the payment of a 'penalty,' that is not a 'rigid criterion' of its deductibility. Third, we say that there was positive and compelling evidence that to allow such a deduction would not frustrate the policies of the underlying act."

The underlying act was the Emergency Price Control Act of 1942 (Approved 1/30/42) (Pub. Law 421—77th Cong. 2nd Sess.) (56 Stat. 23), hereinafter referred to as E.P.C.A. of 1942.

In the *Jerry Rossman* case, petitioner was a converter of textile products which shrunk in the process of dyeing. In setting the price to customers, O.P.A. permitted petitioner to claim a working allowance shrinkage. Petitioner discovered that it had claimed a shrinkage allowance larger than O.P.A. regulations allowed and, thus, had over-

charged its customers and subjected itself to the Administrator's claim for treble damages. However, before the Administrator made an investigation, petitioner brought the matter to his attention and settled his claim by paying to him the exact amount of the overcharges. Petitioner deducted from gross income the amount of the payment to O.P.A. and the Commissioner disallowed the deduction and was sustained in this disallowance by the Tax Court.

Under Section 205(e) E.P.C.A. of 1942, when prices were charged in excess of the ceilings established by O.P.A. regulations, there immediately arose in favor of the Administrator, or the ultimate consumer, the following claim:

a. For the amount of overcharges, plus,

b. Twice the amount of the overcharge, plus,

c. Attorneys' fees, plus,

d. Court costs.

Where there was no wilful violation of the ceiling prices, it was the policy of the Administrator to accept the exact amount of the overcharges[1] in full settlement of his claim.

Where there was a wilful violation, but no court action involved, it was the Administrator's policy to accept the exact amount of the overcharges, plus one-half thereof. (See *Garibaldi & Cuneo,* 9 T. C. 446, Sept. 25, 1947.)

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[1]"It has been our policy to adjust cases involving innocent violations by payment of merely the amount of the overcharge. Congress gave the Administrator discretion to decide in what cases treble damage actions should be brought." Chester A. Bowles, Admr., O.P.A., in Hearings before the Senate Banking and Currency Committee on S. 1764, 78th Cong., 2nd Sess. 1944, p. 1415.

Where there was a wilful violation and court action was necessary, but settlement was made before trial, it was the Administrator's policy to accept the overcharge plus one-half thereof, plus court costs in full settlement of his claim. (See *Garibaldi & Cuneo,* 9 T. C. 446.)

The *Jerry Rossman* case involved deductibility of the exact amount of the overchange, restitution of which was made by payment to the Administrator instead of to the customer who was overcharged.

Counsel is informed that Petitioner's payment involved herein is the exact amount of overcharges, but there is no proof on this in the record. It is petitioner's contention that payment to the Administrator of the exact amount of the overcharge plus any additions thereto (one-half, two times, attorney's fees and costs) is a deductible expense, without distinction as to type of payment. In the event this court is of the opinion that payment of the amount of overcharges is a deductible business expense and payment of any additions thereto is not a deductible business expense, under the unfavorable assumption (because of no proof) that petitioner's payment was the amount of the overcharge plus one-half thereof, petitioner would be entitled to a deduction of $8,714.05. Or, in such an event, the case could be remanded for further proof on this point.

Judge Hand, in the *Jerry Rossman* case, said:

> "* * * First, it seems apparent to us that the payment of the overcharge—which is all that is here involved—can on no theory be treated as the payment of a 'penalty.' Taken in its broadest sense, that word has a punitive, as opposed to a remedial, meaning; it covers fines and other exactions which are not restitution for a wrong, and are only justified, either as

> a deterrent, or in order to satisfy an atavistic craving for retaliation. A seller's duty to return the overcharge to the 'terminal buyer': that is, to one 'who buys * * * for use, or consumption other than in the course of trade or business,' is so clearly not a 'penalty' under this definition that no argument can make it plainer than its bare statement. The only possible excuse for confusion is that Sec. 205(e) gave to the 'terminal buyer' a claim, not only to recover the overcharge, but twice its amount in addition; * * * However, the Administrator's claim, like the 'terminal buyer's' claim for which it is a substitute, is also made up of the overcharge and an addition of twice its amount; and the Commissioner must maintain that the part of it, which is made up of the overcharge, is a 'penalty' and loses its character as restitution even though the Administrator demands only the overcharges. There is no basis for such a conclusion."

Speaking of the exact amount of the overcharge, it is difficult to understand how the respondent can contend that the disgorging of an overcharge, or the restitution of a sum of money to which one is not entitled, is a penalty payment. The essential characteristic of a penalty is punishment for wrong-doing, such as requiring payment of the wrongdoer's *own* money or suffering imprisonment. To use an extreme illustration, if the only sanction imposed for theft were the return to the Government of the property stolen, it would be odd to say that thieves were being penalized.

Speaking of the payment in excess of the overcharge, Section 205 of the E.P.C.A. of 1942 (subsection (e) gives the Administrator the claim for treble damages) deals entirely with "Enforcement." Each of its seven subsec-

tions, from (a) to (g) deals in meticulous fashion with a variety of remedies.

In a context of such extraordinary precision, words are necessarily freighted with sharp distinctions. Not only does subsection (e) as amended deal with "a judgment in an action for damages under this subsection," but subsection (b) provides the real penalty of "fine" or "imprisonment." Moreover, subsection (d), which complements (b) and (e) expressly deals with both "damages" and "penalties," thereby impressively emphasizing the contemplated distinction when the word "damages" was used.

If any doubts persist, they are removed by the legislative commentaries, which regard a consumer's suit and the Administrator's suit as cognate "actions for damages." (Sen. Rep. No. 922, 78th Cong., 2nd Sess. (1944) 13.)

In *Crary v. Porter,* 157 F. 2d 410, 414 (C. C. A. 8), the Court said of Section 205(e):

> "In any attempted discussion therefore of whether the provision for increasing or multiplying the amount of an overcharge could be in any sense a real penalty, it would not be possible to maintain that under the statute the seller was being made to pay more than the actual damages which he had occasioned."

And Douglas, J., in *Hulbert v. Twin Falls County,* 327 U. S. 103, 105, said the treble damage provisions "are remedial, not punitive in nature."

If petitioner had repaid the overcharge plus an addition thereon to a consumer instead of the Administrator of O.P.A. "in compromise or settlement of pending or contemplated litigation in such cases," it would have constituted damages deductible as ordinary and necessary

business expenses, according to Respondent's official ruling in I.T. 3627, C.B. 1943, p. 111, wherein he said consumer actions are "remedial in nature." See also I.T. 3762, C.B. 1945, p. 95. In I.T. 3630, C.B. 1943, p. 113, the Commissioner also ruled that a seller may deduct payments made to the United States because of overcharges on sales to consumers entitled to sue under Section 205(e). However, the Commissioner in 1946 reversed this latter rule by I.T. 3799, C.B. 1946-1, p. 56, and I.T. 3800, C.B. 1946-1, p. 82.

Without any cogent reasons for a distinction, the Commissioner ruled in the same I.T. 3627, C.B. 1943, p. 111, that payments to the Administrator like the one involved herein are not deductible because they "are in the nature of penalties for law violation."

If a customer paid an overcharge on an item for use or consumption in his trade or business, he was not permitted to sue. In such a case, the Administrator was given the right to sue. Inasmuch as it was a violation of the Regulations to pay over the ceiling prices the law makers apparently thought it would be inconsistent to permit the violator (the buyer for use in trade or business) to sue for the overcharge. Hence the buyer's suit was confined to the ultimate consumer, or, to quote Mr. Henderson, "the housewife in effect." See Hearings before the Senate Committee on Banking and Currency on the Emergency Price Control Act, 77th Cong., 1st Sess. (1940) 141.

Penalties have no monetary relation to the damage done or loss sustained by the overcharged buyer. Sec. 205(b) provided a $5,000 fine or two years in prison as the "punishment for crime or offense" as Penalty is defined by Webster's Collegiate Dictionary (5th Ed.).

However, Sec. 205(e) provided for damages for "the estimated reparation in money for injury sustained" (see definition Damages, Webster's Collegiate Dictionary) which is measured by the amount of the overcharge.

POINT II.

Even if It Be the Payment of a Penalty, Its Allowance as a Business Expense Deduction Would Not Frustrate Any Sharply Defined National Policy.

The disallowance as a business expense deduction of penalties, the allowance of which would frustrate a sharply defined national policy is a "judicial gloss" as Judge Hand said in the *Jerry Rossman* case:

> "The Revenue Act does not declare that penalties may not be deducted; the doctrine is a judicial gloss—and for that matter, a gloss of the lower courts only, save as the Supreme Court recognized it by implication in Commissioner v. Heininger." (320 U. S. 467.)

On the question of whether the allowance of the payment of the overcharge as a business expense deduction would frustrate a sharply defined national policy, Judge Hand had the following to say:

> "This conclusion leads directly to the third question: whether, even though the overcharge was a 'penalty,' its allowance as a deduction would 'frustrate' any 'sharply defined policies' of the Emergency Price Control Act of 1942. It is impossible to find an answer in general terms; indeed any answer goes to the very root of one's theory of criminal law. Happily, in the case at bar, we are not left to specula-

tion, for we have an answer from the best possible source—the Administrator himself. The body of regulations, by which the United States sought to control prices during the last war, was extraordinarily complicated and difficult to comprehend. That was inevitable; the innumerable varieties of commercial transactions to be covered made possible nothing simpler. One may indeed argue, as the Commissioner does, that the more unsparing and relentless was the pursuit of offenders, however innocent they may have been of any wilful violation of the regulations, the more solicitous would they become to comply, and the more effective would be the enforcement of the Act. That had been a school of penology since the time of Draco; but it has not been the only school, and, as we read Commissioner v. Heininger, *supra,* the Supreme Court did not accept it. The Administrator did not believe that such a rigid and uncompromising policy was the best way to realize the purposes of the Act. When the amendment to Sec. 205(e) was being considered in 1944, he declared in a letter to the Senate Committee 'that the protection of innocent violators from excessive damage was obviously desirable'; and that it had been his 'policy to adjust cases involving innocent violations by payment of merely the amount of the overcharge.' He thought that Congress had given him discretion not to sue for 'treble damages' in some instances, and he had exercised that discretion so as 'to avoid undue hardship in deserving cases.' In short, he did not believe that it paid to sweep into the same pool with wilful or careless violators, violators for whom the daedalian mazes of the regulations had proved too much. Moreover, Congress showed in 1944 by the amendment of Sec. 205(e) that it agreed with the Administrator. It seems to us that we should accept these expressions

as evidence that in cases where the Administrator accepted the overcharge as sufficient, it did not 'frustrate' any 'sharply defined' policies of the Emergency Price Control Act of 1942."

Furthermore, as the Supreme Court said in the *Heininger* case:

> "The language of 23(a) contains no express reference to the lawful or unlawful character of the business expenses which are declared to be deductible." (320 U. S. at 474.)

And to adopt the language of that opinion to the present circumstances, a denial of the deduction attaches "a serious punitive consequence" to the Administrator's finding, which is purely *ex parte* and not impartial, and "which Congress has not expressly or impliedly indicated should result from such a finding." (*Id.* at 474-5.)

And as Judge Denham said in *Helvering v. Hampton,* 79 F. 2d 358, 361 (C. A. 9th, 1935):

> "Even if unethical conduct in business were extraordinary, restitution therefore is ordinarily expected to be made from the person in the course of whose business the wrong was committed. It is therefore deductible under Sec. 214(a)(1)." (Revenue Act of 1921, which is same as Sec. 23(a), Internal Revenue Code.)

It is not easy to understand what "sharply defined" national policy would be frustrated if an overcharge, which has already been taxed once as income, is deducted when paid back. Under the penalty doctrine, the feared frustration is the mitigation of the penalty through its deduction from otherwise taxable income. Here, however, the appli-

cation of the penalty doctrine of nondeductibility would impose a "serious punitive consequence" rather than mitigate an existing punitive consequence. The taxpayer not only returns the overcharge itself, but pays income or excess profits taxes as if the overcharge were never returned. Indeed national policy was effecuated, not frustrated, by requiring the return of the overcharge plus additions thereon to compensate for the expense and trouble of securing the restitution plus damages suffered.

Conclusion.

In view of the foregoing, it is believed that petitioner is entitled to deduct the $13,071.08 paid to the Administrator in July, 1944. Therefore, the decision of the Tax Court should be reversed and it should be directed to enter a decision in favor of petitioner.

Respectfully submitted,

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